

Internal Revenue Service
memorandum

CC:TL-N-3382-91
Br2:RLOverton

date: APR 29 1991

to: District Counsel, Manhattan CC:MAN

from: Assistant Chief Counsel (Tax Litigation) CC:TL

subject: Request for Tax Litigation Advice concerning
[REDACTED]

Chapter 11 Case No. [REDACTED]
United States Bankruptcy Court
[REDACTED]

This responds to your request for technical assistance in connection with the above-mentioned case.

ISSUES

1. Whether [REDACTED], as the purchaser of limited partnership interests at a price substantially below fair market value, realized ordinary income in [REDACTED] under I.R.C. § 83 to the extent that the fair market value of the partnership interests acquired in [REDACTED] exceeded the amount paid.

2. Whether pursuant to Treas. Reg. § 1.83-6(a)(2) [REDACTED] should be denied the compensation deduction, attributable to those limited partnership interests transferred to its employees for performance of services, on account of [REDACTED]'s failure to withhold on such amounts.

FACTS

In [REDACTED], [REDACTED] approached [REDACTED] to ascertain whether [REDACTED] would be interested in exploring a management buyout. On [REDACTED], [REDACTED] entered into an agreement and plan of merger whereby [REDACTED], a wholly owned subsidiary of [REDACTED], offered to purchase [REDACTED] shares of [REDACTED] stock for cash of \$ [REDACTED] per share. Both [REDACTED] and [REDACTED] had been organized by [REDACTED] for purposes of transacting this acquisition. The remainder of the [REDACTED] outstanding shares of [REDACTED] stock were to be converted into 1) the right to receive subordinated debentures of [REDACTED] and 2) the right

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to receive a pro rata share of the warrants to purchase an aggregate of █% of the common equity of █.

In order to facilitate the acquisition of █, █ needed approximately \$█. These funds were to be utilized to purchase the common stock of █, as well as to pay the expenses incurred by █ in connection with the █ financing, offer, and merger. Accordingly, █ caused █ to borrow \$█ from banks and to issue high-yield securities consisting of \$█ of █% senior subordinated debentures due █, \$█ of █% subordinated debentures due █ and merger debentures in the amount of \$█. In addition, █ also agreed to have warrants issued entitling its holder to purchase █ common stock. Finally, █ issued \$█ of preferred stock to unrelated investors and sold \$█ of █ common stock at \$█ per share to █ equity limited partners.

█, on behalf of the acquisition corporation (█), retained the services of █ to underwrite the high-yield debt securities, the proceeds of which would be applied toward the acquisition. █ agreed to underwrite the necessary securities on a firm commitment basis.

On █ a limited partnership (█) was formed solely to acquire and hold warrants in █. The sole limited partner of █ was █, which provided █ percent of the purchase price of the warrants as a capital contribution to █ in exchange for █ percent of the interest in █. The general partner of █ was █, a limited partnership controlled by █'s principals. The general partner contributed █ percent of the cost of the warrants to █ as a capital contribution in exchange for a █ percent interest in █. These contributions were made simultaneously with the closing of the leveraged buyout transaction, and █ used the proceeds to purchase the warrants from the acquisition corporation █. A warrant purchase agreement was executed between █ and █ which gave █ the right to purchase warrants equal to █ shares of █ common stock representing approximately █% of the shares in █. These warrants were exercisable at \$█ per share for an exercise period of █ years extending from the date of issuance until █. The sole assets of █ were the common stock warrants acquired from █.

These partnership interests were allegedly purchased with the intent to sell them to the public. However, based upon the facts given to us, it was determined (1) that some of the partnership interests were retained by [REDACTED]; (2) some of these interests were transferred to employees of [REDACTED] in what we can only assume was in exchange for services; and (3) some of the interests were conveyed to mutual fund managers as an inducement for the mutual funds to purchase the preferred stock of [REDACTED].

DISCUSSION

I.R.C. section 83(a) provides that if, in connection with the performance of services, property is transferred to any person other than the person for whom such services were performed, the excess of the fair market value of such property over the amount paid for such property shall be included in the gross income of the service provider in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or not subject to a substantial risk of forfeiture.

Treas. Reg. § 1.83-7 provides that if an option is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value at the time the option was granted. The person who performed such services realizes compensation upon such grant at the time and in the amount determined under section 83(a). If section 83(a) does not apply to the grant of such option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time.

Reg § 1.83-7(b) provides that when an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. The regulation then sets forth four criteria which must be met before the taxpayer can assert that an option has a readily ascertainable fair market value.

Reg. § 1.61-2(d) provides "...if property is transferred to an employee or independent contractor as compensation for services, for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for such property and the amount of its fair market value at the time of

the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income."

Issue One

In the instant case [REDACTED], performed underwriting services for [REDACTED] through its efforts in facilitating the issuance of various [REDACTED] securities (including debentures and stock). In connection with the performance of such services limited partnership interests in [REDACTED] were transferred to [REDACTED]. Accordingly, section 83 is applicable.

Under the partnership agreement, prior to the distribution of any assets in kind in the event of a liquidation or termination of the partnership, the partners' capital accounts shall be adjusted to account for investment gain or loss in the assets. Prior to the liquidation or termination of the partnership, the capital accounts of the partners would be adjusted as though the assets of [REDACTED] to be distributed in kind had been sold for their value in cash and the resulting investment gain or loss would then be credited or debited to the capital accounts of the partners. Thus, the partnership interests received by [REDACTED] represent an interest in the assets of [REDACTED] including any additional gain or loss attributable to such assets. As such, these interests are capital interests in said partnership. Accordingly, this case does not present the issue of whether under section 83 the value of a mere profits interest in a partnership can be taxed upon receipt.

[REDACTED] performed services for [REDACTED], but ostensibly received the limited partnership interests, i.e. property, from another entity [REDACTED]. To invoke section 83, however, property need only be transferred in connection with the performance of services, as opposed to being transferred directly in exchange for the services. Accordingly, the fact that [REDACTED] performed services for [REDACTED], but ostensibly received property, i.e. the limited partnership interests, from a different entity, [REDACTED], does not preclude the application section 83. Thus, to invoke section 83 it is unnecessary for the government to explain the substance of a transaction whereby services were performed by [REDACTED] for [REDACTED] party, [REDACTED], but property, i.e., limited partnership interests, was transferred to [REDACTED] from another party ([REDACTED]) in connection with the performance of services. Nevertheless, as an aid to understanding this case, we are providing you with the following description of what we believe to be the underlying substance of the instant transaction.

██████████ can be considered to have transferred the ██████ limited partnership interests to ██████ in exchange for warrants in ██████. ██████ can then be viewed as having performed underwriting services for ██████ and also as having conveyed some money to ██████ in exchange for those limited partnership interests in ██████. Some of the partnership interests were retained by ██████, some can be considered to have been transferred to ██████ employees for services performed, and the remaining interests can be considered either (1) to have been sold to mutual funds (along with preferred stock) and then conveyed by the mutual fund to its fund manager, presumably, as compensation or (2) to have been conveyed to the fund managers as an incentive payment to facilitate the sale of the preferred stock of ██████. See, the attached diagrams.

Section 83 provides that the amount included in the service provider's gross income is the fair market value of the property received over the amount paid for such property. Accordingly, the fair market value of the partnership interests received by ██████ less the dollar amount paid by ██████ should be included in ██████'s gross income (as ordinary income) in the first taxable year in which its rights in such property are transferable or are not subject to a substantial risk of forfeiture. The partnership interests were received by ██████ in ██████. For purposes of valuing the partnership interests, the only assets of the partnership are the warrants to purchase ██████ stock. Since we believe that the partnership entity must be respected, the partnership interests rather than the warrants must be treated as the property received by ██████ and therefore it is the partnership interests that must be valued. Therefore, to the extent the value of the partnership interests received by ██████ in exchange for services exceeds the amount paid for such interests, ██████ realized ordinary income under I.R.C. section 83 at the time of the transfer in the taxable year ██████.

The value of the partnership interests would be taxed to ██████ as ordinary income in ██████ the year they were received and transferable, if a value can be established. However, if the fair market value of property received is not ascertainable, taxation may be postponed. See, Burnet v. Logan 283 U.S. 404 (1931). Generally, only in rare and extraordinary cases will property be considered to have no ascertainable fair market value. See, Treas. Reg. § 1.1001-1(a). Yet, where options are received in connection with the performance of services, the valuation standard employed under Reg. § 1.83-7 for postponing taxation on account of lack of determinable value is one of readily ascertainable fair market value. Moreover, Reg. § 1.83-7 provides that an option that is not actively traded on an established market does not have a "readily ascertainable value" unless its fair market value can otherwise be determined with

reasonable accuracy. The property received by [REDACTED] in connection with its performance of services was not warrants (i.e., options), but rather limited partnership interests. Arguably, limited partnership interests are not subject to the readily ascertainable value standard of Reg. § 1.83-7 and therefore are subject to the ascertainable fair market value standard.

The value of the partnership interests must, however, be based on the value of the warrants taking into account the power to exercise or transfer said warrants retained by the general partner, [REDACTED]. Accordingly, a court may well choose to apply the readily ascertainable standard applicable to warrants under Reg. § 1.83-7 in considering taxpayer's contention that the taxation of the partnership interests should be postponed until the warrants are exercised or otherwise disposed of. As such, we recommend that in valuing the partnership interests the four criteria of Reg. § 1.83-7(b)(2) be considered.

Although a [REDACTED] valuation of the partnership interests is difficult, we note that under either valuation standard [REDACTED] has the burden of proving that the partnership interests cannot be valued in [REDACTED]. The value determined by the Service is to be afforded a presumption of correctness.

We note that in addition to the expert's appraisal the readily ascertainable value for the partnership interests upon receipt in [REDACTED] might be arrived at by reference to the price for which some of the partnership interests were arguably sold to the mutual funds. That is, we understand that some of the partnership interests were conveyed to mutual fund managers as an inducement for the mutual funds to purchase the preferred stock of [REDACTED]. Although the partnership interests went to the personal accounts of the fund managers, they can be considered as having been acquired by the mutual funds along with the preferred stock. As such, the value of the partnership interests might be determined by subtracting the value of the preferred stock from the total purchase price paid by the mutual fund to acquire the stock and the partnership interests.

Issue Two

Subsequent to the transfer of the partnership interests to [REDACTED] in connection with its performance of underwriting services, [REDACTED] can be viewed as having transferred some of the partnership interests to its employees for services performed. In addition, [REDACTED] can be viewed as having sold some of the interests to unrelated third parties, the mutual fund managers, as well as having retained some of the partnership interests.

Reg. § 1.83-6(a) provides a special rule which states that in the case of the transfer of property in connection with the

performance of services a deduction is allowable under section 162 or 212, to the person for whom such services were performed. Under section 83(h) the amount of the deduction is equal to the amount included as compensation in the gross income of the service provider under section 83 but only to the extent such amount meets the requirements of section 162 or 212 and the regulations thereunder. However, pursuant to Reg. § 1.83-6(a)(2) this deduction is only allowed if the employer deducts and withholds upon such amount in accordance with section 3402.

Under a strict application of this regulation to transfers of the partnership interests by [REDACTED] to its employees for services performed, [REDACTED] would only be allowed a commensurate compensation deduction for the value of the interests transferred if [REDACTED] deducted and withheld on such amounts. However, if such amounts were included or are eventually included in gross income by the employees it would be difficult to deny the compensation deduction to [REDACTED] on account of its failure to withhold. That is, if employees do include such amounts in their gross incomes the Service would be unable to demonstrate any harm to the government resulting from [REDACTED]'s failure to withhold. Moreover, such income inclusion by the employees can be argued to have actually satisfied the "included" language of section 83(h). For taxable years prior to July 21, 1978, an employer who failed to withhold on amounts transferred in connection with the performance of services was still allowed the deduction provided the employees reported such amounts in gross income. For these reasons, if the employees reported or subsequently report the value of the partnership interests received in their gross incomes we believe there are very substantial litigating hazards associated with denying the compensation deduction under Reg. § 1.83-6(a)(2). Thus, to the extent that no deduction preclusion argument is advanced by the Service, [REDACTED] can be argued to have realized ordinary income under section 83, based upon the receipt of the partnership interests, but should also receive a commensurate compensation deduction in [REDACTED] equal to the value of those partnership interests transferred to [REDACTED]'s employees for services performed.

Of course, as to those partnership interests retained by [REDACTED] no deduction issue arises.

The partnership interests which were not retained by [REDACTED] or transferred to its employees were transferred to mutual fund managers as an incentive for purchasing preferred stock in [REDACTED]. These partnership interests might be considered as having been sold to the mutual fund itself (which in turn conveys it to its employee, the mutual fund manager) along with [REDACTED] preferred stock. As such, these partnership interests can be considered as having been purchased by the mutual fund itself from [REDACTED]. [REDACTED]'s basis in these partnership interests

would then be the allocable cash consideration received for the partnership interests, plus the difference between the amount paid for such property and its fair market value, to the extent included in gross income as compensation income. See, Treas. Reg. § 1.61-2(d). Thus, as a result of the sales of these interests to the mutual funds [REDACTED] would be entitled to deductions either as a cost of goods sold or as a basis offset to amounts realized.

On the other hand, the conveyance of these partnership interests to the mutual fund managers to induce sales of the preferred stock could also be considered as an ordinary and necessary expense incurred to facilitate the sale of the preferred stock of [REDACTED] and therefor deductible under section 162. Hence, with respect to those partnership interests conveyed to the mutual fund managers [REDACTED] would be entitled to some type of deduction or basis offset commensurate with the asserted section 83 income.

CONCLUSION

To the extent the value of the partnership interests in [REDACTED] received by [REDACTED] in connection with the performance of services exceeds the value paid by [REDACTED] for such interests, [REDACTED] realized ordinary income under I.R.C. section 83. See also, Treas. Reg. § 1.61-2(d). This position hinges upon a determination of the value of the partnership interests received in [REDACTED] which must be based upon a valuation of the warrants in [REDACTED], the sole asset of [REDACTED]. Reg. § 1.83-6(a)(2) provides authority to disallow [REDACTED]'s compensation deduction for failure to withhold on amounts transferred to employees in connection with the performance of services. We believe, however, that this position carries substantial litigating hazards. Moreover, if the employees are shown to have reported or to subsequently report these amounts in gross income then we recommend that the Service concede the deduction preclusion issue.

As to the partnership interests transferred to the fund managers, [REDACTED] is entitled either to a deduction or basis offset commensurate to the compensation income.

We note that this memorandum should not be circulated beyond the Office of Chief Counsel. Further, neither a potential taxpayer nor its counsel should receive a copy or even be made aware that Tax Litigation Advice was requested. CCDM (35)8(12)7.

If you have questions concerning the above discussion or if you need further assistance regarding this matter, please contact Richard L. Overton at (FTS) 566-3470.

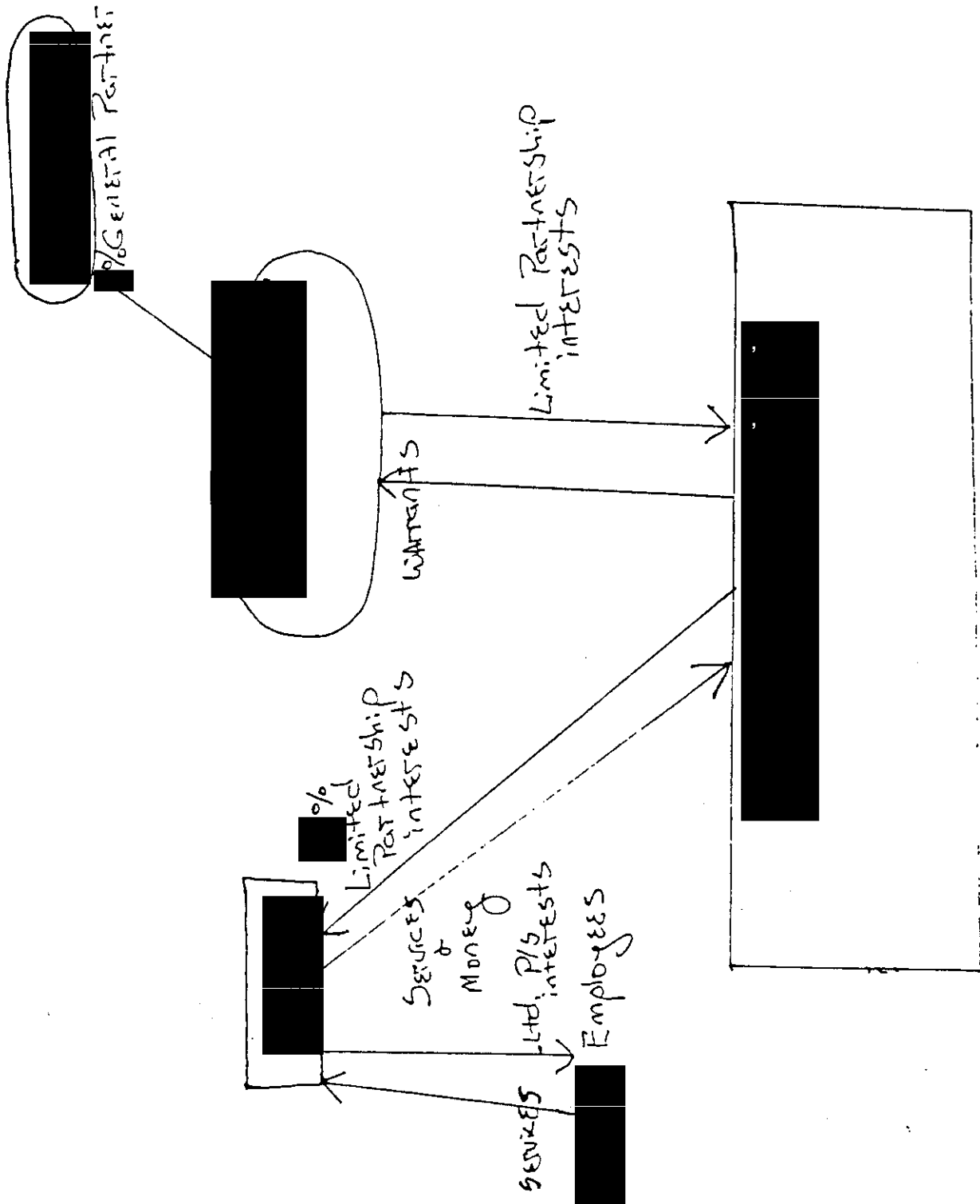
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Attachments:
Diagrams

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